

Internal Revenue Service
memorandum

CC:TL-N-9041-90

Br4:GBFleming

date: **007 18 1990**

to: District Counsel, [REDACTED]
Attention: [REDACTED]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Tax Litigation Advice: [REDACTED] --
Electrowinning/Depletion Issue

This responds to your memorandum of July 25, 1990, requesting tax litigation advice regarding whether to accept the taxpayer's proposed settlement or to litigate the electrowinning issue raised in the audit of the taxpayer's tax years [REDACTED] through [REDACTED].

ISSUE

Whether to accept the taxpayer's offer to concede [REDACTED] percent of the adjustment of its depletion deduction, which treated the electrowinning process employed at its [REDACTED] and [REDACTED] mines as a mining cost of copper production in calculating percentage depletion under I.R.C. §§ 613(c)(4)(D) and (5).

CONCLUSION

Although the opinion in Ranchers Exploration & Development Corp. v. United States, 634 F.2d 487 (10th Cir. 1980), recognizes electrowinning as a mining process with respect to copper, Sunshine Mining Co. v. United States, 827 F.2d 1404 (9th Cir. 1987) and the Service do not follow the holding on that issue. See Rev. Rul. 83-99, 1983-2 C.B. 100. Thus, the taxpayer is not entitled to treat electrowinning as a mining process. Since the Seventh Circuit has not ruled on this issue (and any appeal from the Tax Court would be heard in that circuit), we have no objection to acceptance of the taxpayer's offer to concede [REDACTED] percent of the amount at issue which is a realistic weighing of the hazards of litigating this issue in the Tax Court.

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FACTS

During tax years [REDACTED] through [REDACTED], the taxpayer's [REDACTED] and [REDACTED] mines used a solvent extraction and electrowinning process in conjunction with leaching to recover copper from the raw ore. Leaching is a process whereby acid is sprinkled on the copper oxide ore dumps and is allowed to percolate through the ore. The resulting solution contains ions of copper at a low concentration in an aqueous medium. To increase the concentration, the solution is subjected to solvent extraction.

Solvent extraction involves contacting the copper solution with a reagent carried in a kerosene medium. This process separates the copper in the leaching solution from impurities and transfers the copper ions to the organic solution. The organic solution containing the copper is then subjected to sulfuric acid, which extracts the copper from the organic solution and forms an enriched, concentrated electrolyte.

During the electrowinning process, an electric current is passed from an anode to a copper cathode, called a starter sheet, both of which are submerged in the concentrated copper electrolyte. This current causes copper from the electrolyte to precipitate and adhere to the starter sheets. The starter sheets initially weigh approximately 10 pounds. After about a week of electrowinning, the weight of the cathodes increases to approximately 130 pounds.

At each stage of the solvent extraction and electrowinning processes, substantial amounts of impurities are removed until the copper cathodes are in a high degree of purity. The copper is not in a shipping grade and form until it is subjected to the electrowinning process.

On its returns for the tax years at issue, the taxpayer treated electrowinning as a mining process in calculating its percentage depletion allowance on copper produced from the [REDACTED] and [REDACTED] mines. On examination the Service determined that the taxpayer improperly treated electrowinning as a mining process and adjusted the taxpayer's depletion allowance accordingly.

DISCUSSION

The allowance for percentage depletion on copper is 15 percent of the gross income from the property, but no more than 50 percent of the taxpayer's taxable income from the property. I.R.C. §§ 613(a), (b)(2). The term "gross income from the property" is defined in I.R.C. § 613(c)(1) as the

gross income from mining, which is defined to include not only the extraction of ores or minerals from the ground but also the treatment processes considered as mining under I.R.C. § 613(c)(4). For copper, I.R.C. § 613(c)(4)(D) identifies several mining processes, including "precipitation (but not including electrolytic deposition . . .)." Moreover, I.R.C. § 613(c)(5) provides that electrolytic deposition is not to be considered as a mining process "[u]nless . . . otherwise provided for in paragraph (4) (or . . . necessary or incidental to processes so provided for)." As an electrolytic deposition process, electrowinning is thus expressly excluded from the mining processes recognized under the statute for purposes of percentage depletion on copper.

Notwithstanding the unambiguous language of the Code, the United States Court of Appeals for the Tenth Circuit held in Ranchers Exploration & Development Corp. v. United States, 634 F.2d 487 (10th Cir. 1980), that electrowinning, as used by the taxpayer in that case, is an allowable mining treatment process. The court acknowledged that electrowinning is generally a form of electrolytic deposition but rejected a literal construction of the statute. Applying a "function and purpose" test, the court concluded that the term "electrolytic deposition" as used in the parenthetical of I.R.C. § 613(d)(4)(D) encompasses only processes (such as roasting, thermal or electric smelting and refining) that beneficiate a solid metal or partially processed ore to such an extent that they constitute smelting, refining or manufacturing. Thus, the court reasoned that the statute does not expressly exclude electrowinning from allowable mining processes. On that basis, the Tenth Circuit concluded that electrowinning is an allowable mining process in the taxpayer's operations because it extracts the first identifiable valuable mineral from the raw ore leach solution. The court also concluded that electrowinning qualifies as mining under I.R.C. § 613(c)(5) because it is necessary to leaching, which is a mining process.

In Rev. Rul. 83-99, 1983-2 C.B. 100, the Service declined to follow Ranchers Exploration to the extent it recognizes electrowinning as an allowable mining process. The ruling expressly stated that "the Service will continue to treat electrowinning as electrolytic deposition, a nonmining process under section 613(c)(4)(D) and section 613(c)(5)." 1983-2 C.B. at 101.

The Service's position on electrowinning was upheld by the Ninth Circuit in Sunshine Mining Co. v. United States, 827 F.2d 1404 (9th Cir. 1987). In that case the taxpayer used electrowinning to recover antimony from a solution obtained by leaching a silver-copper concentrate in hot sodium sulfide.

The court rejected the taxpayer's arguments that electrowinning is substantially equivalent to precipitation, that the process should be considered as mining because it separates valuable minerals from valueless ore, and that electrowinning is a mining process under I.R.C. § 613(c)(5) because it is necessary or incidental to the leaching of the silver-copper concentrate and the recovery of antimony.

The Sunshine Mining court expressly stated its disagreement with Tenth Circuit's opinion in Ranchers Exploration but distinguished that case on three grounds: (1) the electrowinning process in Ranchers Exploration replaced the taxpayer's use of cementation, which was an acknowledged mining process; (2) the Ninth Circuit would have been inclined to treat electrowinning as a nonmining process if the resulting solid were sufficiently pure for commercial purposes, but the antimony recovered through electrowinning by Sunshine Mining is commercially usable; and (3) electrowinning was used in Ranchers Exploration to obtain the first valuable mineral from the raw ore, unlike Sunshine Mining's recovery of antimony as a byproduct after several grades of valuable ore have been separated and sold.

If the electrowinning issue is litigated in the instant case, the taxpayer could appeal to the Seventh Circuit or the Federal Circuit (if the taxpayer pursues a refund action in the United States Claims Court), neither of which has ruled on the issue. Although in Sunshine Mining the Ninth Circuit suggested distinctions between that case and Ranchers Exploration, in our opinion, the Ninth Circuit's analysis in Sunshine Mining is as equally applicable to the recovery of copper as to antimony. Accordingly, we believe that Sunshine Mining should control our position in this case.


As indicated in your memorandum, the taxpayer has offered to concede [REDACTED] percent of the proposed adjustment attributable to the electrowinning issue. Although we believe that the entire amount of the proposed adjustment is proper, we acknowledge that there are risks in litigating this issue in the Seventh Circuit (or the Federal Circuit). In particular, we recognize that the taxpayer's use of electrowinning to recover copper from the ore more closely resembles the processing in Ranchers Exploration than that in Sunshine Mining. Thus, there is a risk that the trial and appellate courts may be inclined at the outset to follow Ranchers Exploration because of the factual similarities.

While we can present a strong argument that the Sunshine Mining rationale applies in this case, we recognize that a realistic balancing of the risks suggests that the taxpayer's offer provides a reasonable basis for compromise on this

issue. Moreover, in light of the favorable opinion in Sunshine Mining, our published disagreement in Rev. Rul. 83-99 with Ranchers Exploration, and the lack of widespread taxpayer noncompliance, the Service has no compelling need at this time to relitigate the electrowinning issue in order to obtain a conflict among the circuits. Accordingly, we have no objection to acceptance of the taxpayer's settlement offer.

Please contact Gerald B. Fleming at FTS 566-3345 if there are any questions.

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